

§ 1.964-1

26 CFR Ch. I (4-1-08 Edition)

(2) That portion of the minimum distribution which would be required if the provisions of section 963(b)(2) were applicable to such taxable year, which the number of days in such taxable year which are within the surcharge period and after December 31, 1969, bears to the total number of days in such taxable year, and

(3) That portion of the minimum distribution which would be required if the provisions of section 963(b)(3) were applicable to such taxable year, which the number of days in such taxable year which are not within the surcharge period bears to the total number of days in such taxable year.

(b) *Calendar year 1970.* For calendar year 1970, the required minimum distribution shall be an amount determined in accordance with the following table:

If the effective foreign tax rate is (percentage)—	The required minimum distribution of earnings and profits is (percentage)—
Under 9	84.983562
9 or over but less than 10	82.967123
10 or over but less than 18	80.983562
18 or over but less than 19	79.471233
19 or over but less than 26	77.487671
26 or over but less than 27	73.958904
27 or over but less than 32	70.487671
32 or over but less than 33	67.463014
33 or over but less than 36	63.991781
36 or over but less than 37	57.942466
37 or over but less than 39	51.991781
39 or over but less than 40	44.934247
40 or over but less than 41	37.495890
41 or over but less than 42	31.446575
42 or over but less than 43	19.446575
43 or over but less than 44	12.893151
44 or over but less than 45	6.446575
45 or over	0

(c) *Surcharge period.* For purposes of this section the term “surcharge period” means the period beginning January 1, 1968, and ending June 30, 1970.

(d) *Illustration of principles.* The application of the rules set forth in paragraphs (a), (b), and (c) of this section may be illustrated by the following example. It is assumed that all computations are carried to sufficient accuracy:

Example. (a) M, a domestic corporation, and A, its controlled corporation (the one class of stock of which is wholly owned by M), both have a taxable year beginning December 1, 1969, and ending November 30, 1970. For such taxable year M makes a first-tier election with respect to A corporation. The

effective foreign tax rate for such year is 30 percent.

(b) Under section 963(b) and paragraph (b) of this section the surcharge period ends June 30, 1970. Therefore, of the 365 days in the taxable year, 153 days are not within the surcharge period. Of the remaining 212 days, 31 are within the surcharge period and before January 1, 1970 and 181 days are within the surcharge period and after December 31, 1969. If section 963(b)(1) were applicable to the entire taxable year, the required minimum distribution of earnings and profits would be 75 percent. If section 963(b)(2) were applicable to the entire taxable year, the required minimum distribution would be 72 percent. If section 963(b)(3) were applicable to the entire taxable year, the required minimum distribution would be 69 percent.

(c) Under section 963(b) and this section the required minimum distribution of earnings and profits is 71 percent, computed as follows:

$$(75\% \times 31 + 365) + (72\% \times 181 + 365) + (69\% \times 153 + 365) = 71\%.$$

[T.D. 7100, 36 FR 5336, Mar. 20, 1971]

§ 1.964-1 Determination of the earnings and profits of a foreign corporation.

(a)(1) *In general.* For taxable years beginning after December 31, 1986, the earnings and profits (or deficit in earnings and profits) of a foreign corporation for its taxable year shall be computed substantially as if such corporation were a domestic corporation by—

(i) Preparing a profit and loss statement with respect to such year from the books of account regularly maintained by the corporation for the purpose of accounting to its shareholders.

(ii) Making the adjustments necessary to conform such statement to the accounting principles described in paragraph (b) of this section; and

(iii) Making the further adjustments necessary to conform such statement to the tax accounting standards described in paragraph (c) of this section.

(2) *Required adjustments.* The computation described in paragraph (a)(1) of this section shall be made in the foreign corporation's functional currency (determined under section 985 and the regulations under that section) and may be made by following the procedures described in paragraphs (a)(1)(i) through (a)(1)(iii) of this section in an order other than the one listed, as long as the result so obtained would be the

same. In determining earnings and profits, or the deficit in earnings and profits, of a foreign corporation under section 964, the amount of an illegal bribe, kickback, or other payment (within the meaning of section 162(c), as amended by section 288 of the Tax Equity and Fiscal Responsibility Act of 1982 in the case of payments made after September 3, 1982, and the regulations issued pursuant to section 964) paid after November 3, 1976, by or on behalf of the corporation during the taxable year of the corporation directly or indirectly to an official, employee, or agent in fact of a government shall not be taken into account to decrease such earnings and profits or to increase such deficit. No adjustment shall be required under paragraph (a)(1)(ii) or (iii) of this section unless it is material. Whether an adjustment is material depends on the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or merely a nonrecurring nature. For the treatment of earnings and profits whose distribution is prevented by restrictions and limitations imposed by a foreign government, see section 964(b) and the regulations issued pursuant to section 964. For rules for determining the earnings and profits (or deficit in earnings and profits) of a foreign corporation for taxable years beginning before January 1, 1987, for purposes of sections 951 through 964, see 26 CFR 1.964-1(a) (revised as of April 1, 2006).

(b) *Accounting adjustments*—(1) *In general*. The accounting principles to be applied in making the adjustments required by paragraph (a)(1)(ii) of this section shall be those accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates, including the following:

(i) *Clear reflection of income*. Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect.

For example, an adjustment will be required where an allocation is made to an arbitrary reserve out of current income.

(ii) *Physical assets, depreciation, etc.* All physical assets (as defined in paragraph (e)(5)(ii) of this section), including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost. For special rules for determining historical cost where assets are acquired during a taxable year beginning before January 1, 1950, or a majority interest in the foreign corporation is acquired after December 31, 1949, but before October 27, 1964, see subparagraph (2) of this paragraph.

(iii) *Valuation of assets and liabilities*. Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section. For example, an adjustment will be required where inventory is written down below market value. For the definition of market value, see paragraph (a) of § 1.471-4.

(iv) *Income equalization*. Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph (c) of this section.

(v) *Foreign currency*. If transactions effected in a foreign currency other than that in which the books of the corporation are kept are translated into the foreign currency reflected in the books, such translation shall be

made in a manner substantially similar to that prescribed by paragraph (d) of this section for the translation of foreign currency amounts into United States dollars.

(2) *Historical cost.* For purposes of this section, the historical cost of an asset acquired by the foreign corporation during a taxable year beginning before January 1, 1963, shall be determined, if it is so elected by or on behalf of such corporation—

(i) In the event that the foreign corporation became a majority owned subsidiary of a United States person (within the meaning of section 7701(a)(30)) after December 31, 1949, but before October 27, 1964, and the asset was held by such foreign corporation at that time, as though the asset was purchased on the date during such period the foreign corporation first became a majority owned subsidiary at a price equal to its then fair market value, or

(ii) In the event that subdivision (i) of this subparagraph is inapplicable but the asset was acquired by the foreign corporation during a taxable year beginning before January 1, 1950, as though the asset were purchased on the first day of the first taxable year of the foreign corporation beginning after December 31, 1949, at a price equal to the undepreciated cost (cost or other basis minus book depreciation) of that asset as of that date as shown on the books of account of such corporation regularly maintained for the purpose of accounting to its shareholders.

For purposes of this subparagraph, a foreign corporation shall be considered a majority owned subsidiary of a United States person if, taking into account only stock acquired by purchase (as defined in section 334(b)(3)), the United States person owns (within the meaning of section 958(a)) more than 50 percent of the total combined voting power of all classes of stock of the foreign corporation entitled to vote. The election under this subparagraph shall be made for the first taxable year beginning after December 31, 1962, in which the foreign corporation is a controlled foreign corporation (within the meaning of section 957), or for which it is included in a chain or group under section 963(c)(2)(B) or (3)(B) (applied as if section 963 had not been repealed by

the Tax Reduction Act of 1975), or has a deficit in earnings and profits sought to be taken into account under section 952(d) or pays a dividend that is included in the foreign base company shipping income of a controlled foreign corporation under § 1.954-6(f). Once made, such an election shall be irrevocable. For the time and manner in which an election may be made on behalf of a foreign corporation, see paragraph (c)(3) of this section.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. Corporation M is a controlled foreign corporation which regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices prevalent in country X, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects an allocation to an arbitrary reserve out of current income and depreciation allowances based on replacement values which are greater than historical cost. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices, will have to be eliminated from the statement, an increase in the amount of profit (or a decrease in the amount of loss) thereby resulting.

Example 2. In 1973, Corporation N is a foreign corporation which is not a controlled foreign corporation but which is included in a chain, for minimum distribution purposes, under section 963(c)(2)(B). Corporation N regularly maintains books of account for the purpose of accounting to its shareholders in accordance with the accounting practices of country Y, the country in which it operates. As a consequence of those practices, the profit and loss statement prepared from these books of account reflects the inclusion in income of stock dividends and of corporate distributions representing a return of capital. Adjustments are necessary to conform such statement to accounting principles generally accepted in the United States. Assuming these adjustments to be material, the unacceptable practices will have to be eliminated from the statement, a decrease in the amount of profit (or increase in the amount of loss) thereby resulting.

(c) *Tax adjustments—(1) In general.* The tax accounting standards to be applied in making the adjustments required by paragraph (a)(1)(iii) of this section shall be the following:

(i) *Accounting methods.* The method of accounting shall reflect the provisions of section 446 and the regulations thereunder.

(ii) *Inventories.* Inventories shall be taken into account in accordance with the provisions of sections 471 and 472 and the regulations thereunder.

(iii) *Depreciation.* Depreciation shall be computed as follows:

(a) For any taxable year beginning before July 1, 1972; depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(b) If, for any taxable year beginning after June 30, 1972, 20 percent or more of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with the provisions of § 1.312-15.

(c) If, for any taxable year beginning after June 30, 1972, less than 20 percent of the gross income from all sources of the corporation is derived from sources within the United States, then depreciation shall be computed in accordance with section 167 and the regulations thereunder.

(iv) *Elections.* Effect shall be given to any election made in accordance with an applicable provision of the Code and the regulations thereunder and these regulations.

Except as provided in subparagraphs (2) and (3) of this paragraph, any requirements imposed by the Code or applicable regulations with respect to making an election or adopting or changing a method of accounting must be satisfied by or on behalf of the foreign corporation just as though it were a domestic corporation if such election or such adoption or change of method is to be taken into account in the computation of its earnings and profits.

(v) [Reserved]. For further guidance, see § 1.964-1T(c)(1)(v).

(c)(2) through (c)(6) [Reserved]. For further guidance, see § 1.964-1T(c)(2) through (c)(6).

(7) *Revocation of election.* Notwithstanding any other provision of this section, any election made by or on behalf of a foreign corporation (other than a foreign corporation subject to tax under section 882) may be modified or revoked by or on behalf of such cor-

poration for the taxable year for which made whenever the consent of the Commissioner is secured for such modification or revocation, even though such election would be irrevocable but for this subparagraph.

(8) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. X Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by taking inventoriable items into account under the "first-in, first-out" method. A, B, and C, the United States shareholders of X Corporation, own 45 percent, 30 percent, and 25 percent of its voting stock, respectively. For the first taxable year of X Corporation beginning after December 31, 1962, B and C adopt on its behalf the "last-in, first-out" inventory method, notifying A of the action taken. Even though A may object to such action, adjustments must be made to reflect the use of the LIFO method of inventorying in the computation of the earnings and profits of X Corporation with respect to him as well as with respect to B and C.

Example 2. Y Corporation is a controlled foreign corporation which maintains its books, in accordance with the laws of the country in which it operates, by employing the straight-line method of depreciation. D and E, the United States shareholders of Y Corporation, own 51 percent and 10 percent of its voting stock, respectively. For the first taxable year of Y Corporation beginning after December 31, 1962, D adopts on its behalf the declining balance method of depreciation. However, not knowing that E is a United States shareholder of the company, D fails to provide him with notice of the action taken. Assuming that E has filed the return required by section 6046 and the regulations thereunder within the period prescribed by section 6046(d), adjustments in the computation of earnings and profits will not be required with respect to him unless the Director of International Operations notifies him of the action taken within 240 days after the close of Y's taxable year. If notice is not provided to E within this period, he will not be compelled to make the adjustments. At his option, however, he may accept the action taken by assenting thereto not later than 90

days after he is first apprised of such action by the Director of International Operations.

[T.D. 6764, 29 FR 14628, Oct. 27, 1964; 29 FR 15204, Nov. 11, 1964, as amended by T.D. 6787, 29 FR 18502, Dec. 29, 1964; T.D. 6995, 34 FR 832, Jan. 18, 1969; T.D. 7221, 37 FR 24747, Nov. 21, 1972; T.D. 7322, 39 FR 30931, Aug. 27, 1974; T.D. 7545, 43 FR 19652, May 8, 1978; T.D. 7862, 47 FR 56491, Dec. 17, 1982; T.D. 7893, 48 FR 22510, May 19, 1983; T.D. 9260, 71 FR 24540, Apr. 25, 2006; T.D. 9260, 71 FR 77265, Dec. 26, 2006]

§ 1.964-1T Determination of the earnings and profits of a foreign corporation (temporary).

(a) through (c)(1)(iv) [Reserved]. For further guidance, see § 1.964-1(a) through (c)(1)(iv).

(v) *Taxable years.* The period for computation of taxable income and earnings and profits known as the taxable year shall reflect the provisions of section 441 and the regulations thereunder.

(2) *Adoption or change of method or taxable year.* For the first taxable year of a foreign corporation beginning after April 25, 2006, in which such foreign corporation first qualifies as a controlled foreign corporation (as defined in section 957 or 953) or a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E)), any method of accounting or taxable year allowable under this section may be adopted, and any election allowable under this section may be made, by such foreign corporation or on its behalf notwithstanding that, in previous years, its books or financial statements were prepared on a different basis, and notwithstanding that such election is required by the Internal Revenue Code or regulations to be made in a prior taxable year. Any allowable methods adopted or elections made shall be reflected in the computation of the foreign corporation's earnings and profits for such taxable year, prior taxable years, and (unless the Commissioner consents to a change) subsequent taxable years. However, see section 898 for the rules regarding the taxable year of a specified foreign corporation as defined in section 898(b). Any allowable method of accounting or election that relates to events that first arise in a subsequent taxable year may be adopted or made by or on behalf of the foreign corporation for such year. See paragraph (a)(3)

of this section for the manner in which a method of accounting or a taxable year may be adopted or changed on behalf of the foreign corporation. See paragraph (c)(4) and (g)(3) of this section for applicable rules if the amount of the foreign corporation's earnings and profits became significant for United States tax purposes before a method of accounting or taxable year was adopted by the foreign corporation or on its behalf in accordance with the rules of paragraph (c)(3) of this section. See paragraphs (c)(6) and (g)(2) of this section for special rules postponing the time for taking action by or on behalf of a foreign corporation until the amount of its earnings and profits becomes significant for U.S. tax purposes.

(3) *Action on behalf of corporation*—(i) *In general.* An election shall be deemed made, or an adoption or change in method of accounting or taxable year deemed effectuated, on behalf of the foreign corporation only if its controlling domestic shareholders (as defined in paragraph (c)(5) of this section)—

(A) Satisfy for such corporation any requirements imposed by the Internal Revenue Code or applicable regulations with respect to such election or such adoption or change in method or taxable year (including the provisions of sections 442 and 446 and the regulations thereunder, as well as any operative provisions), such as the filing of forms, the execution of consents, securing the permission of the Commissioner, or maintaining books and records in a particular manner. For purposes of this paragraph (c)(3)(i)(A), the books of the foreign corporation shall be considered to be maintained in a particular manner if the controlling domestic shareholders or the foreign corporation regularly keep the records and accounts required by section 964(c) and the regulations thereunder in that manner;

(B) File the statement described in paragraph (c)(3)(ii) of this section, at the time and in the manner prescribed therein; and

(C) Provide the written notice required by paragraph (c)(3)(iii) of this section at the time and in the manner prescribed therein.

(ii) *Statement required to be filed with a tax return.* The statement required by this paragraph (c)(3)(ii) shall set forth